



EUROPEAN CENTRAL BANK

EUROSYSTEM

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Fragmentation and Rebalancing in the euro area

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Introduction

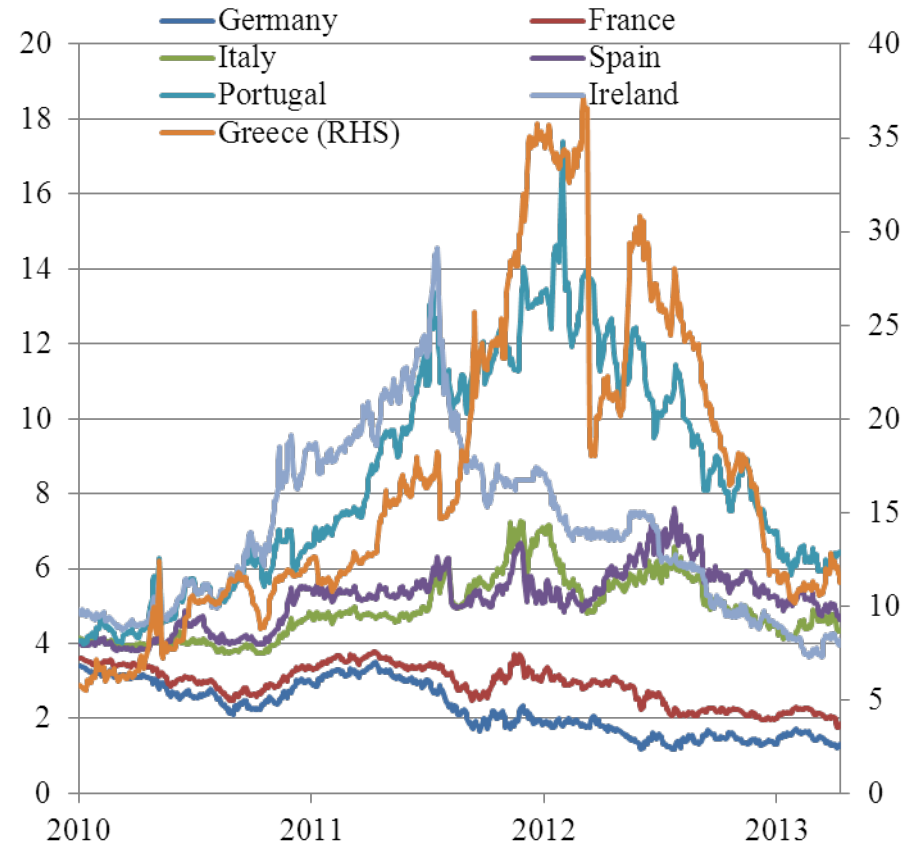
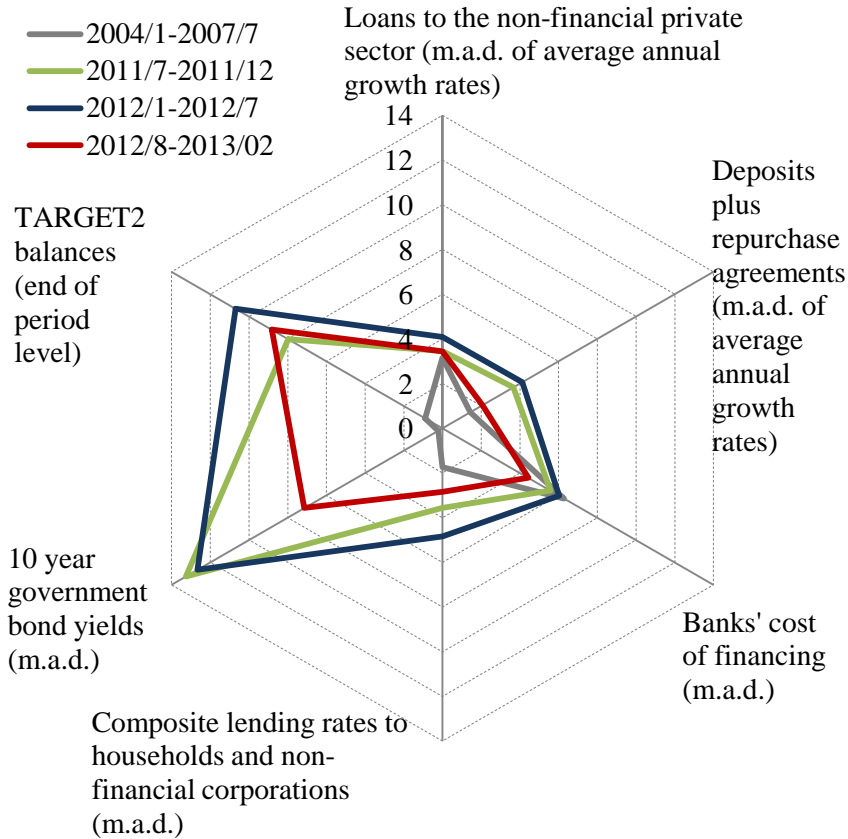
- In the first half of 2012, financial integration continued to suffer as a result of the market perception of redenomination risk that had emerged in the previous year. The notable change in sentiment during the second half of 2012 resulted in a significant **reduction of financial fragmentation** in practically all market segments. Nevertheless, the level of fragmentation remains high in some markets, e.g. money markets, and the climate in the financial markets remains fragile. The improvement was particularly relevant with regard to sovereign bond spreads and yields.
- The receding market fragmentation was the result of **three main factors**:
 - 1) The decisions taken at the June Summit by European leaders to deepen European integration according to long-term objectives of creating a banking, fiscal and political union. These goals were rendered credible by the decision to immediately launch the project of a Single Supervisory Mechanism and the promise of direct European bank's recapitalisation.
 - 2) The announcement by the ECB in August of the launching of Outright Monetary Transactions (OMTs).
 - 3) The **economic rebalancing** in the euro area resulting from the adjustment in both internal and external imbalances achieved by several stressed countries.

Receding (but still high) fragmentation

Policy measures benefited sovereign funding costs

Financial indicators in the euro area (Median absolute deviations (m.a.d.*); end of period €100 bn for TARGET2 balances)

Government bond yields in selected euro area countries
(Jan. 2010 – Apr. 2013, percentage, ten-year maturity)



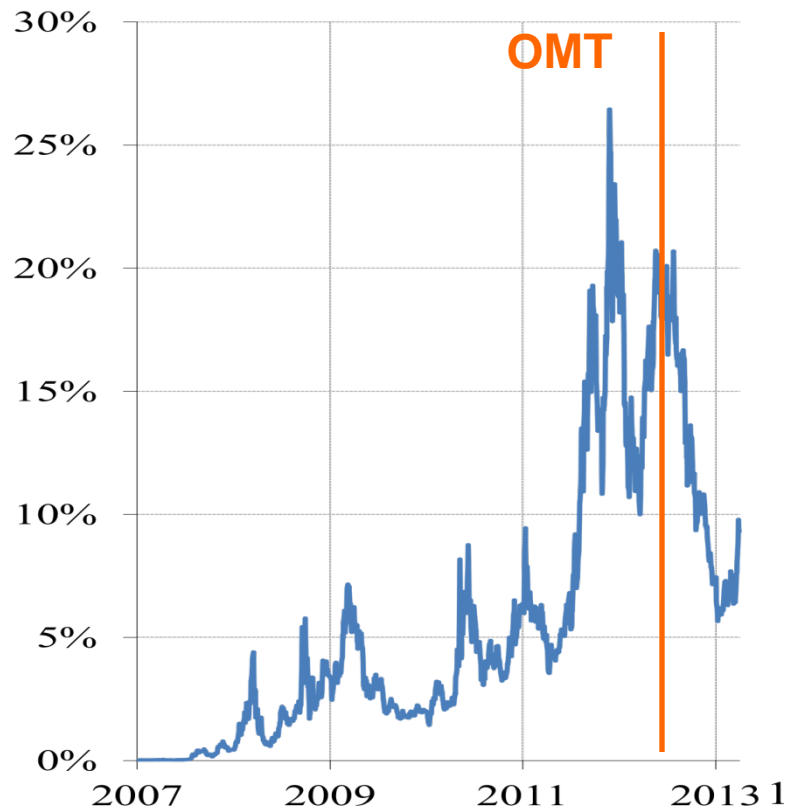
Sources: ECB, ECB calculations.

Notes: *) m.a.d. = Median absolute deviation across selected euro area countries for which historical data are available. The 'm.a.d.' is computed as the cross-country dispersion of the time-averages for each of the four periods. The dispersion measure for 3-year government bond yields has been scaled by 10 for better visualisation.

Source: Bloomberg.

Euro area financial stress indicators improved since mid-2012

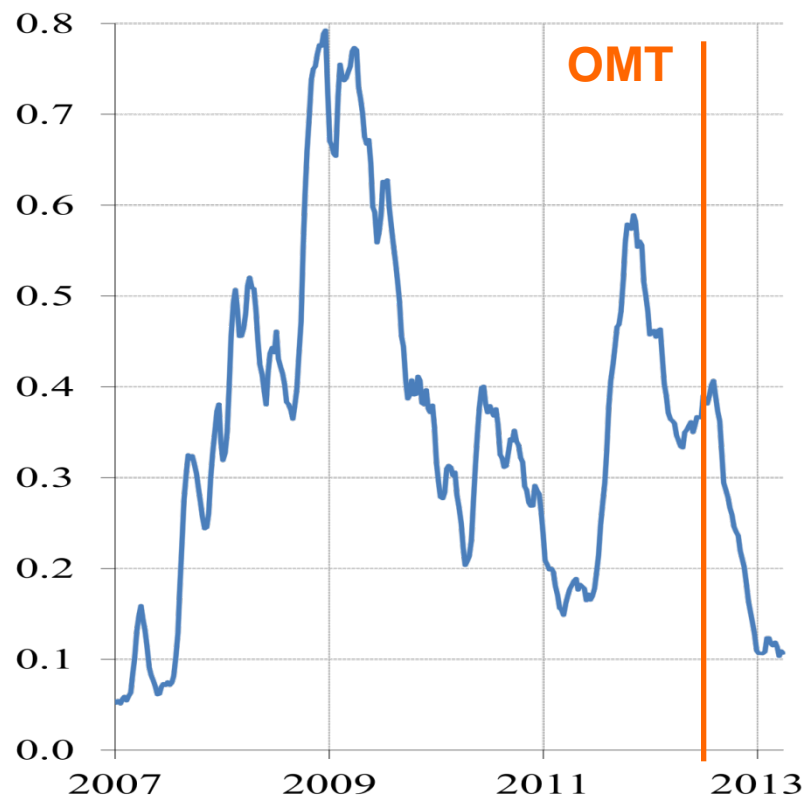
Systemic Risk Measure (SRM) (Jan. 2007 – 01 Apr. 2013; 1-year horizon; five-day moving average)



Sources: Thomson Reuters and ECB calculations.

Notes: Probability of a simultaneous default by two or more euro area LCBGs within one year on the basis of their CDS spreads. See Box 8 in ECB, *Financial Stability Review*, June 2012.

Composite indicator of systemic stress (CISS) (Jan. 2007 – 29 Mar. 2013; five-day moving average; unit-free and constrained within interval (0,1])



Sources: ECB and ECB calculations.

Notes: The five sub-indices of financial stress (for equity, foreign exchange, bond and money markets, as well as for the financial intermediaries) are aggregated by taking into account the time-varying cross-correlations between the sub-indices, i.e. by putting relatively more weight on situations in which stress prevails in several market segments at the same time. See Special Feature C in ECB, *Financial Stability Review*, June 2011.

Receding (but still high) fragmentation

Policy actions have also attenuated bank funding fragmentation but continued distortions from sovereign stresses

Spread between iBoxx bank bond yield and non-financial corporate bond yield

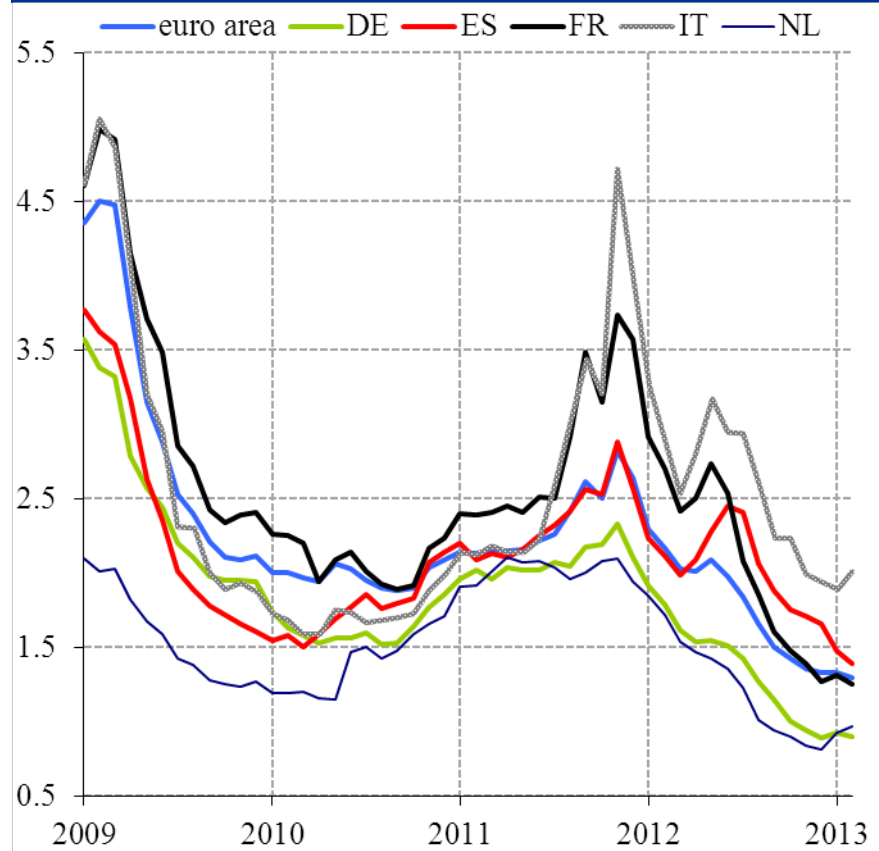
(Jan. 2008 to Apr. 2013; senior debt; basis points)



Sources: iBoxx and ECB calculations.

Composite cost of bank funding

(Jan. 2007 to Feb. 2013; percentages per annum)



Sources: ECB, Merrill Lynch Global index, ECB calculations.

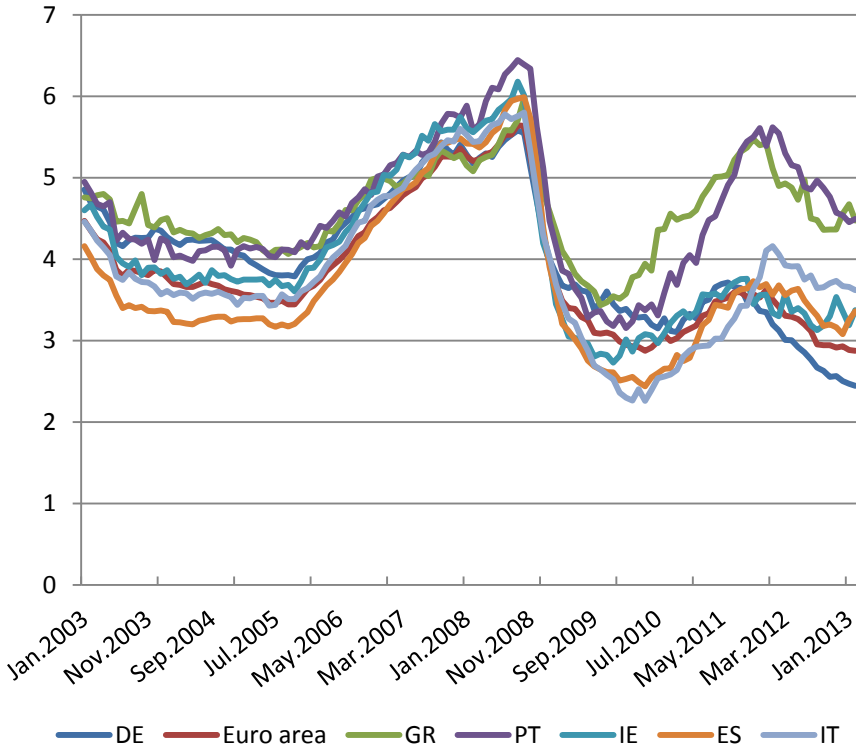
Note: Weighted average of deposit rates on new business and cost of market debt funding.

Receding (but still high) fragmentation

The level of fragmentation remains high in some markets, e.g. lending to non-financial corporations; the climate in the financial markets is fragile.

MFI interest rates (composite rate to households for house purchase and non-financial corporations)

(non-weighted, percentages)

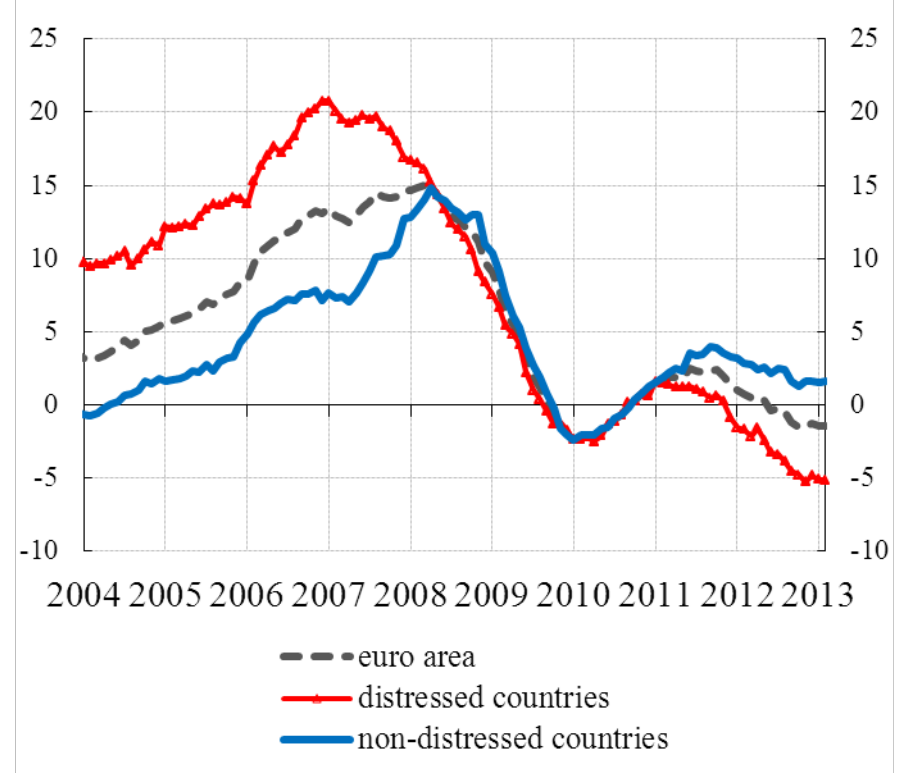


Source: ECB.

Notes: The composite rate is expressed as a non-weighted average of the MFI Interest rates loans to non-financial corporations (total loans) and MFI interest rates loans to households for house purchase (total loans). Loans by total size and total maturity.

MFI loans to non-financial corporations

(annual loan growth; percentages)



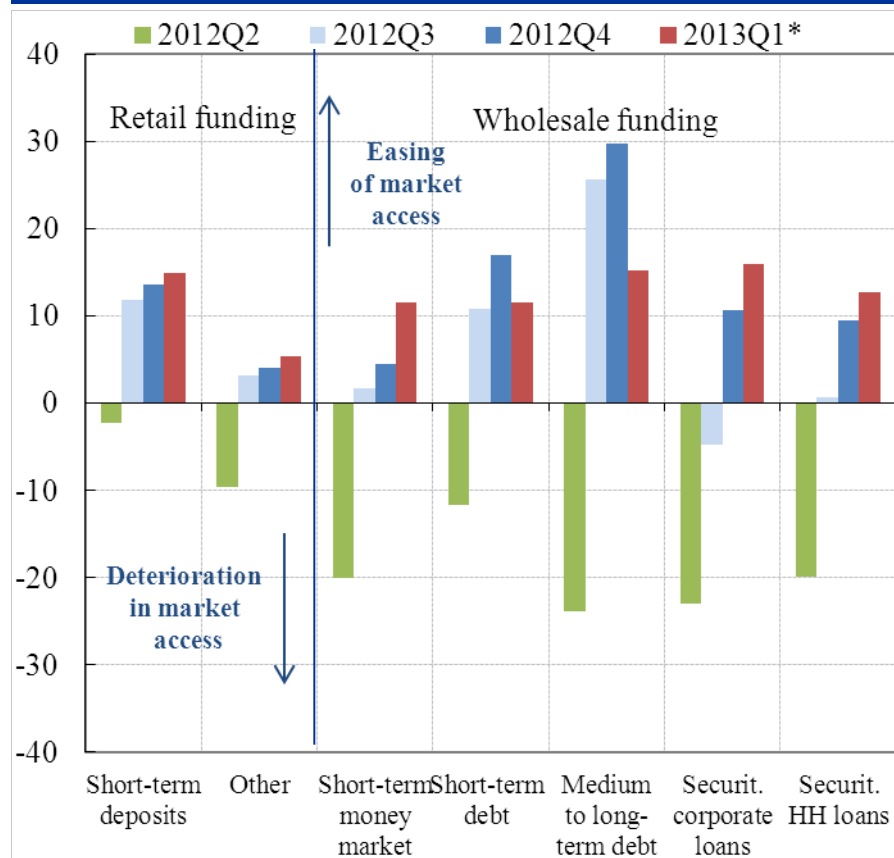
Source: ECB.

Receding (but still high) fragmentation

Improved funding conditions across all major funding sources and also in stressed countries

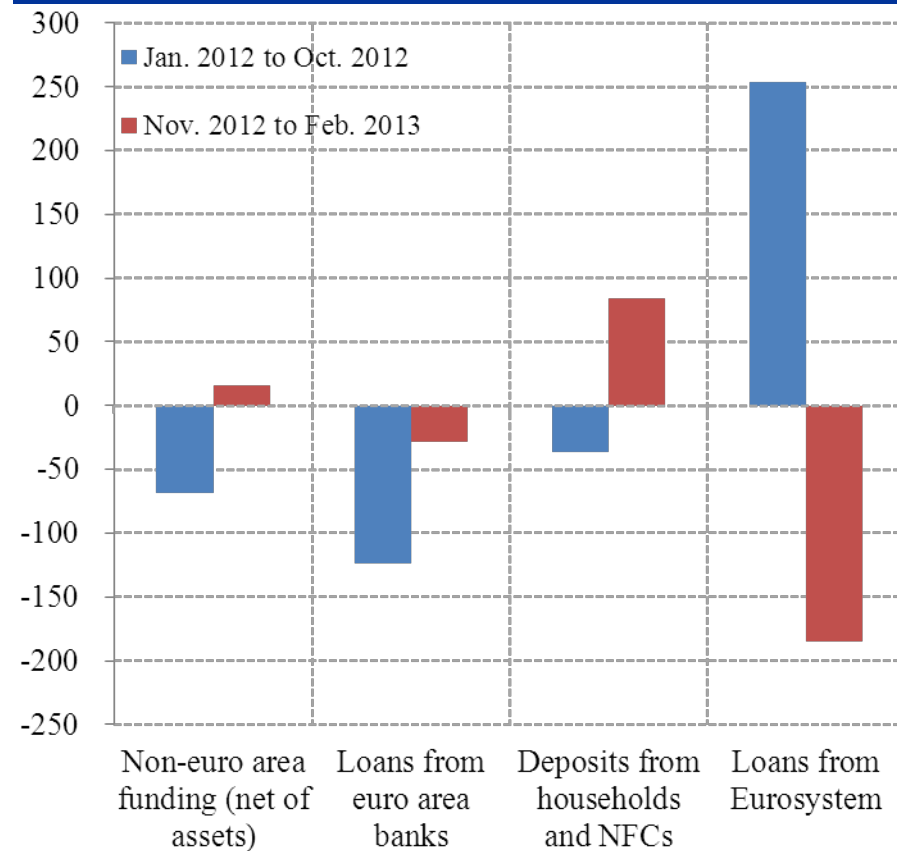
Net percentage of banks reporting improvement in market access

(Q2 2012 to Q1 2013*; net percentages)



Flows in key balance sheet items for banks located in stressed euro area countries

(Jan. 2012 – Feb. 2013; EUR bn)



Source: ECB Bank Lending Survey January 2013.

Note: Figure for 2013Q1 reflects banks' expectations. The net percentages are defined as the difference between the sum of the percentages of banks' reporting that access "eased somewhat" and "eased considerably" and the sum of the percentages reporting that access "deteriorated considerably" and "deteriorated somewhat".

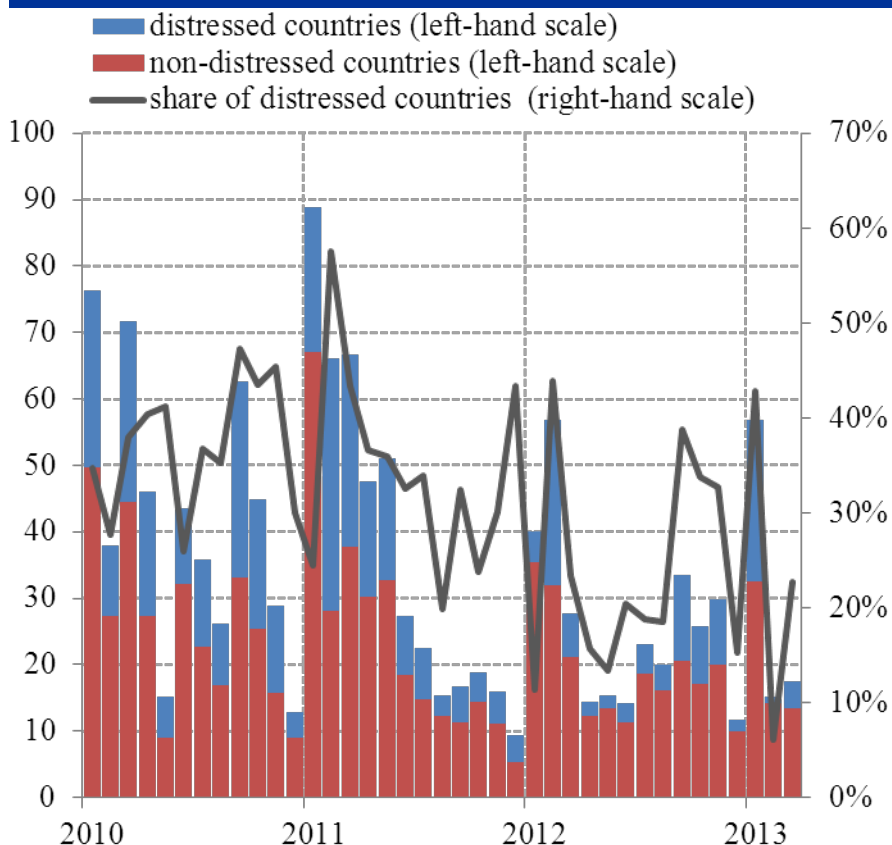
Sources: ECB MFI data and ECB calculations.

Receding (but still high) fragmentation

However debt issuance has tapered off in recent months and fragmentation in funding costs remains

Monthly issuance of medium and long-term debt securities by euro area banks

(Jan. 2010 – Mar. 2013; EUR billions, percentages)

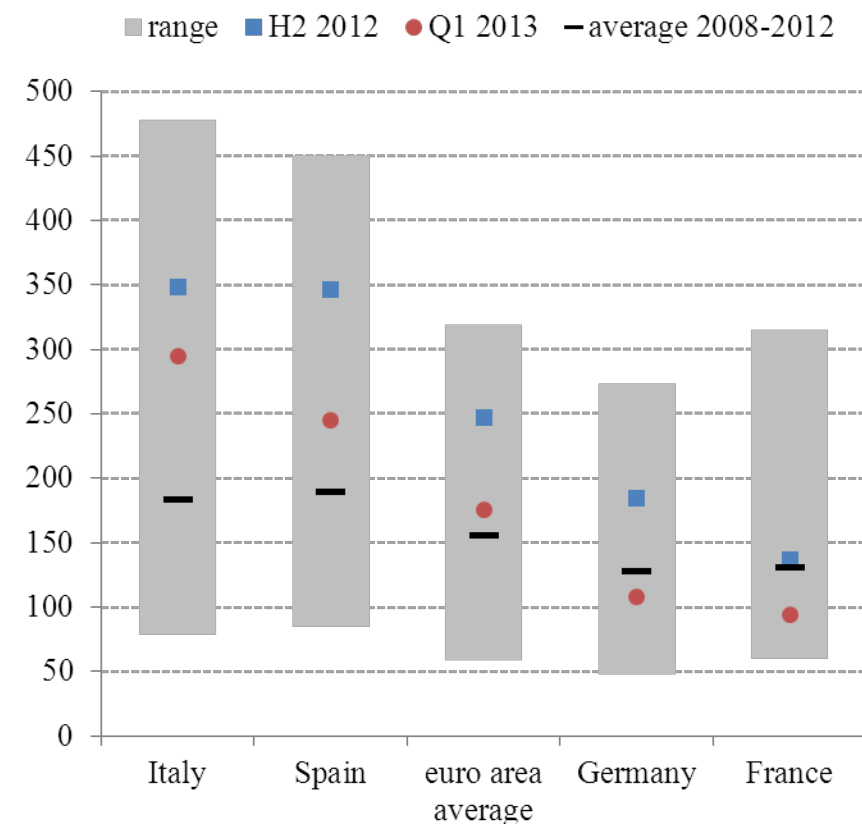


Source: Dealogic.

Notes: Excludes retained deals. "Distressed countries" refer to Cyprus, Greece, Ireland, Italy, Portugal and Spain.

Spreads on senior unsecured debt in selected euro area countries

(Jan. 2008 – Mar. 2013; basis points; spread over swaps)



Sources: Dealogic and ECB calculations.

Notes: Based on EUR-denominated, fixed rate deals with an issue size of at least EUR 250 million. Excludes retained deals.

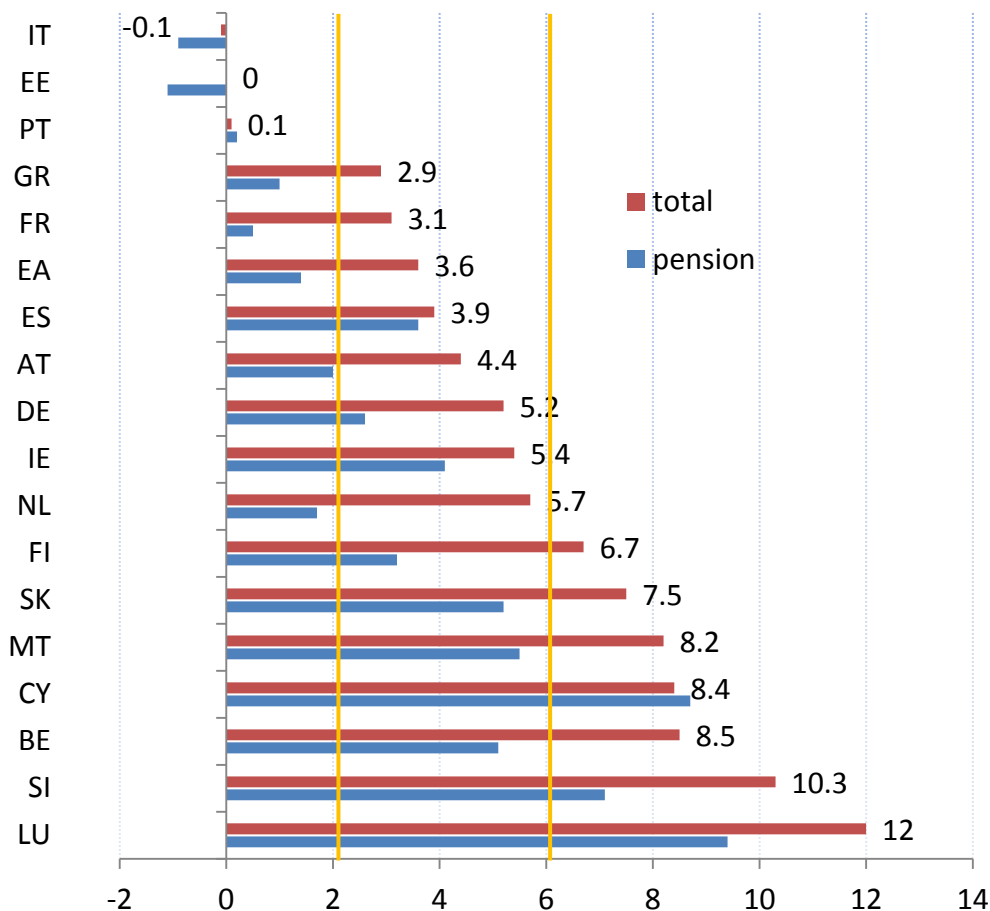
Rebalancing in the euro area

Adjustment in the periphery: public finance

	Public gross debt 2007 (as a % of GDP)	Public gross debt 2012 (as a % of GDP)	Total government budget balance 2012 (as a % of GDP)	Primary government balance 2012 (as a % of GDP)	Change in nominal primary balance 2009-2012 (%)	Change in structural primary balance 2009-2012 (%)
Greece	107.2	161.6	-6.6	-1.5	8.9	14.2
Spain	36.3	88.4	-10.2	-7.2	2.2	3.9
Ireland	24.9	117.2	-7.7	-3.8	8.1	4.3
Portugal	68.4	120.6	-5.0	-0.8	6.5	5.7
Italy	103.3	127.1	-2.9	2.6	3.4	3.6
Euro area	66.4	93.1	-3.5	-0.4	3.1	2.6

Sources: European Economic Forecast, Winter 2013, European Commission

Projected 2010 to 2060 changes in age-related expenditure (as a % of GDP)



Source: Fiscal Sustainability Report 2012, European Commission

Projected total changes 2010-2060 (pensions, health care, education, unemployment):

Small < 2%

IT, EE, PT

2 < Medium < 6%

GR, FR, ES,

AT, DE, IE, NL

Large > 6%

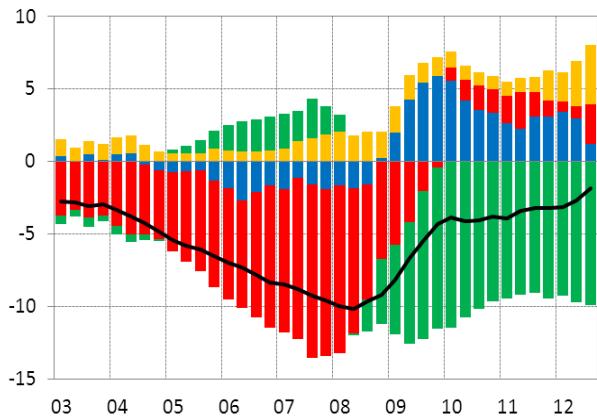
FI, SK, MT, CY,

BE, SI, LU

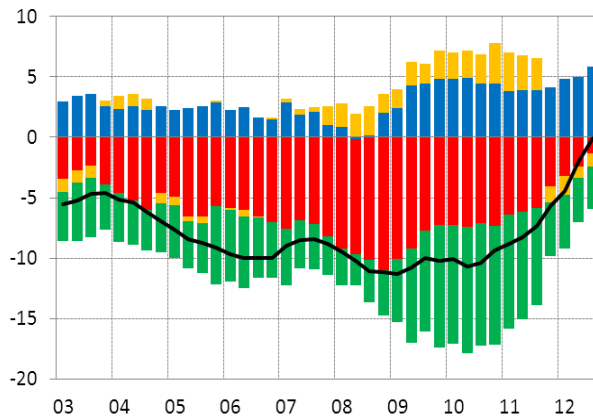
Rebalancing in the euro area

FINANCIAL BALANCES BY SECTOR: total economy, households, non-financial firms, government and the financial sector

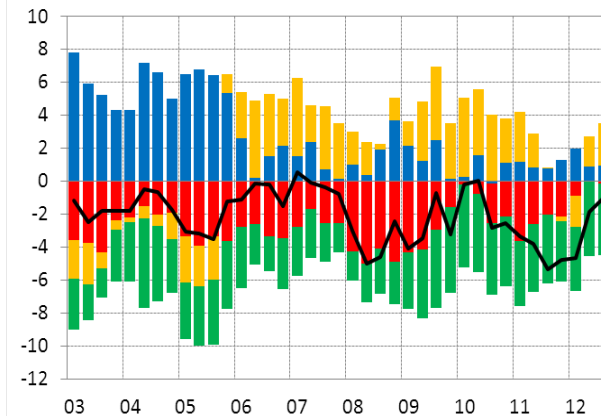
SPAIN



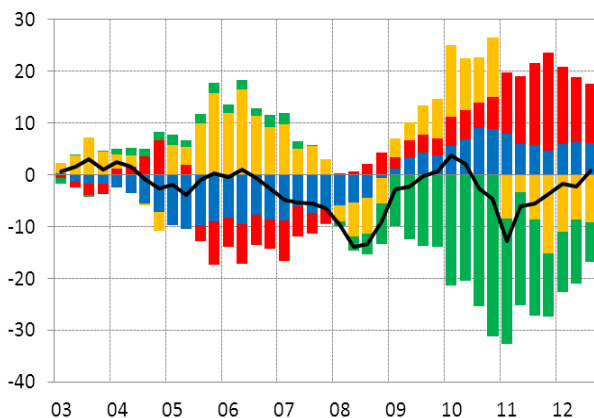
PORTUGAL



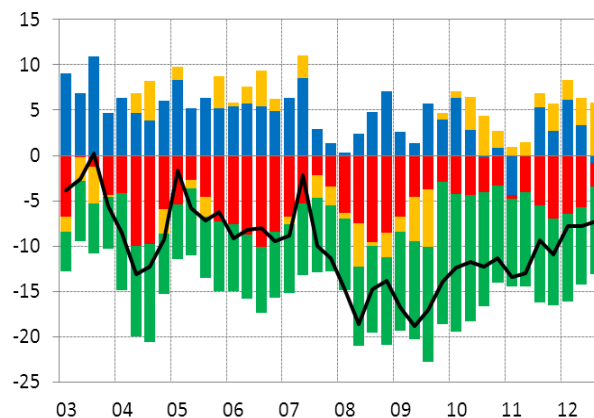
ITALY



IRELAND



GREECE

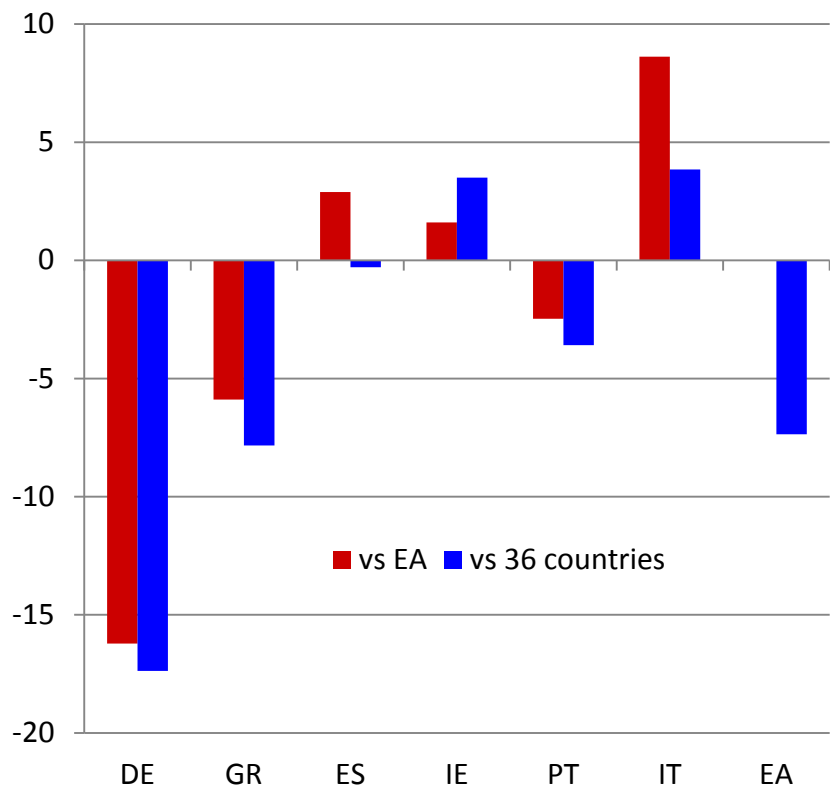


■ NFCs
 ■ Households
 ■ Financial corporations
 ■ General government
 — Total economy/external balance

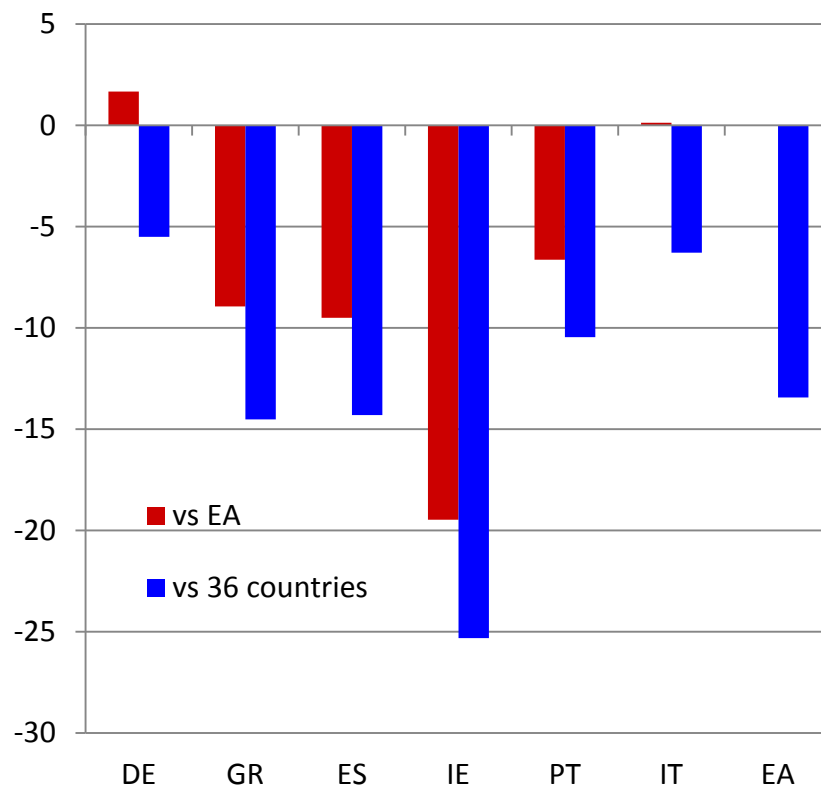
Rebalancing in the euro area

ULC – deflated real effective exchange rates across countries

Percentage changes 1999Q4 to 2012Q3



Percentage changes 2008Q4 to 2012Q3

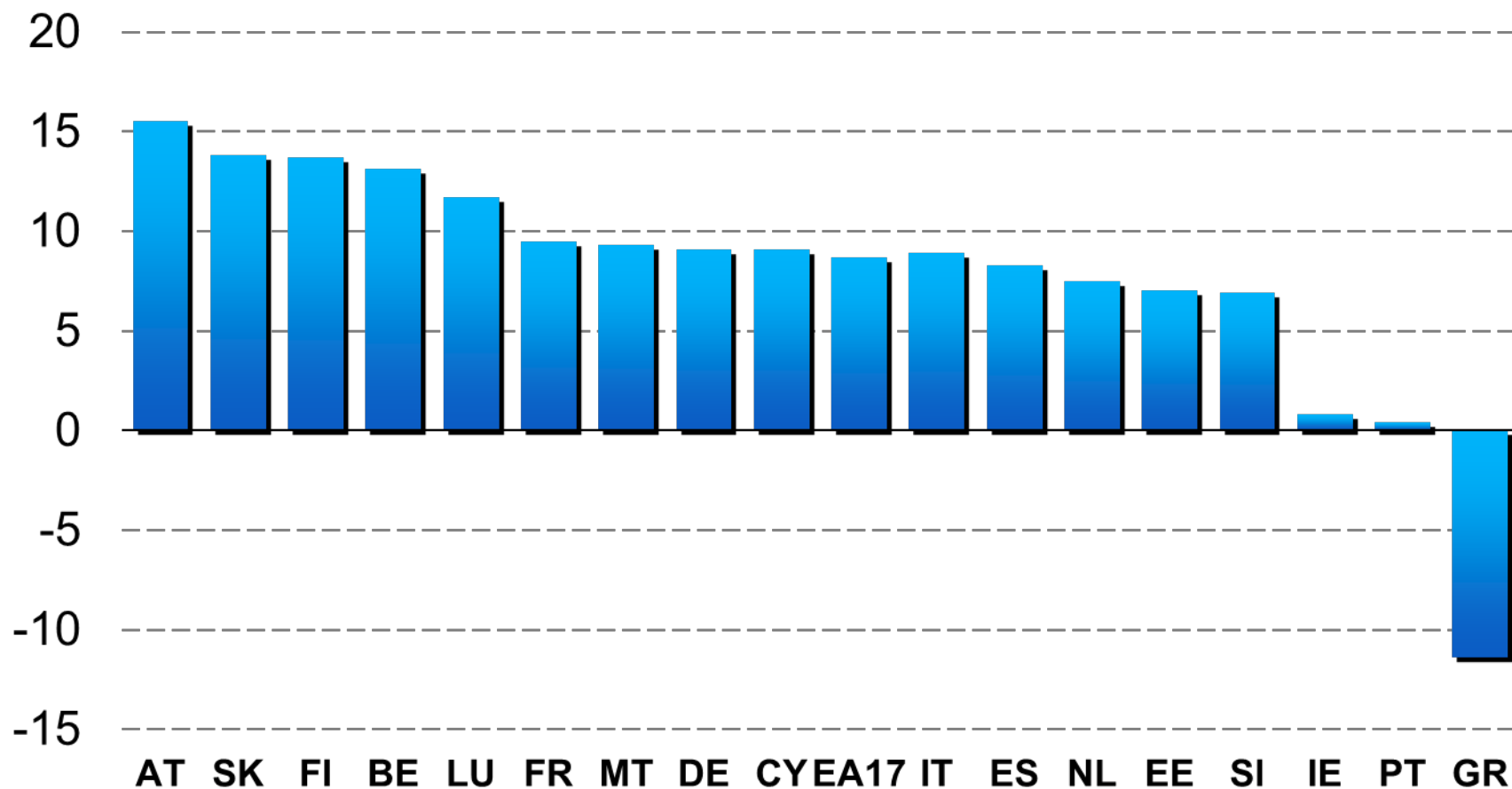


Source: ECB harmonised competitiveness indicators.
Increases (decreases) in the real effective exchange rate signal a worsening (improvement) in competitiveness.

Rebalancing in the euro area

Labour costs per hour - growth from 2008 to 2012 in %

(whole economy except agriculture and public administration)

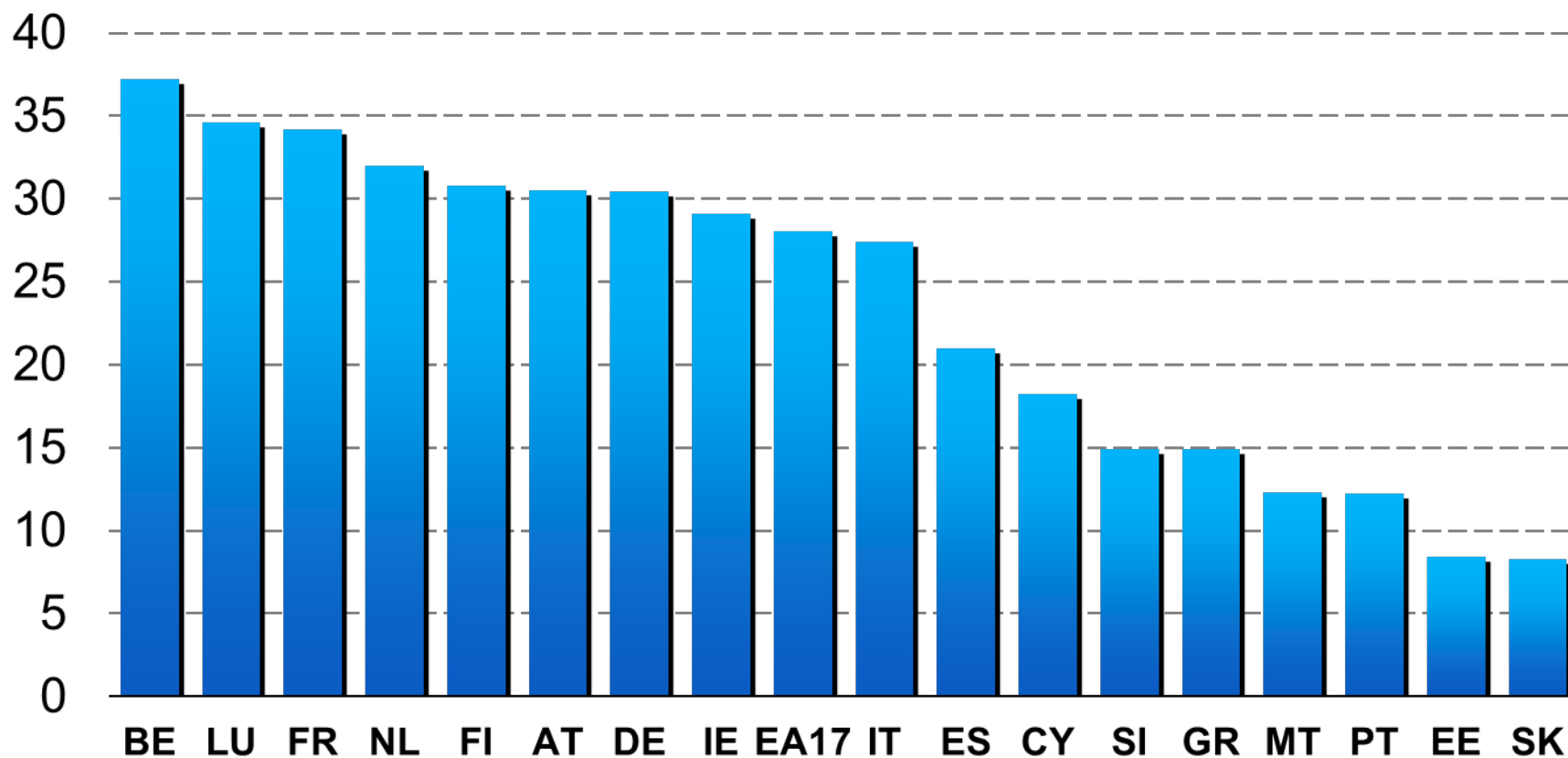


Source: Eurostat.

Rebalancing in the euro area

Labour costs per hour - level in euro in 2012

(whole economy except agriculture and public administration)

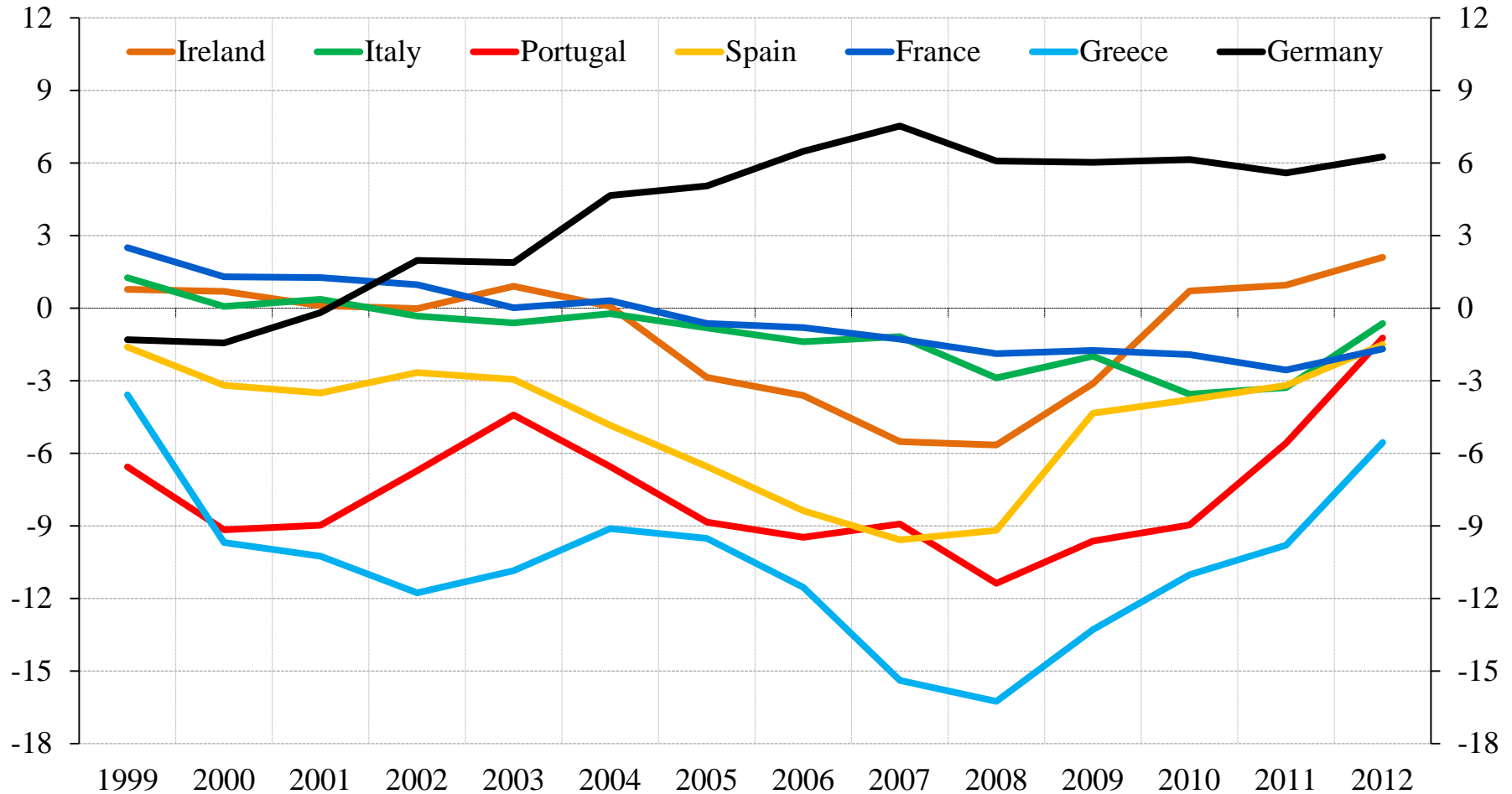


Source: Eurostat.

Rebalancing in the euro area

Evolution of external borrowing (-) / lending (+) since 1999

(in % of GDP)



Rebalancing in the euro area

External borrowing / lending requirements in selected euro area countries

Country	External borrowing (-) /lending (+) in 2012 (% of GDP)	<i>Change from 2009 to 2012 (% of GDP)</i>	Exports of goods and services (vol) - cumulative growth 2009-2012 (in %)	External borrowing (-) /lending (+) in 2013 (% of GDP) (forecast)
Italy	-0.6	1.4	20.3	0.7
Spain	-1.5	2.8	23.4	1.4
Greece	-5.5	7.7	3.4	-2.0
Ireland	2.1	5.2	14.5	3.3
Portugal	-1.2	8.4	22.2	0.5
Slovenia	2.0	2.4	19.1	4.6
Euro area	1.5	1.4	21.5	2.4

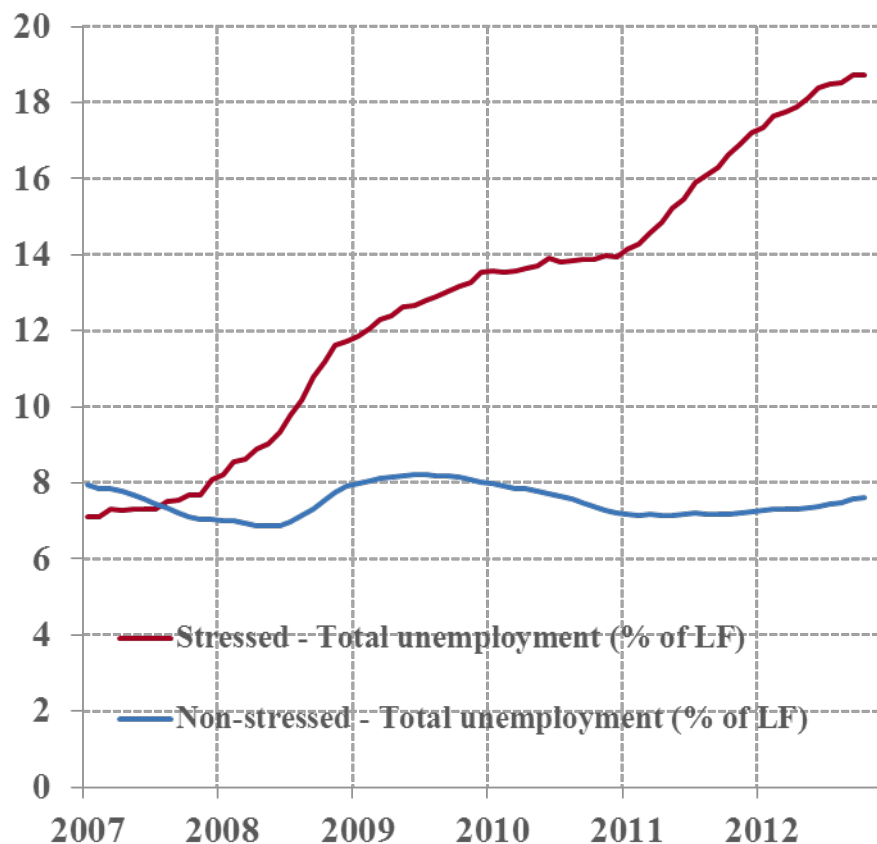
Sources: European Economic Forecast, Winter 2013, European Commission

Rebalancing costs in the euro area

Unemployment rates across countries

Euro area unemployment – stressed vs non-stressed countries

(% of labour force)



Source: Eurostat.

Note: Stressed countries: GR, PT, IE, ES, IT, CY and SI.

Unemployment rates across countries

(% of labour force)

	2008	2009	2010	2011	2012	Feb. 2013*
Greece	7.7	9.5	12.6	17.7	24.3	26.4
Portugal	8.5	10.6	12.0	12.9	15.9	17.5
Ireland	6.4	12.0	13.9	14.7	14.7	14.2
Spain	11.3	18.0	20.1	21.7	25.0	26.3
Italy	6.7	7.8	8.4	8.4	10.6	11.6
Cyprus	3.7	5.4	6.3	7.9	11.9	14.0
Slovenia	4.4	5.9	7.3	8.2	8.9	9.7
Germany	7.5	7.8	7.1	5.9	5.5	5.4
Euro area	7.6	9.6	10.1	10.2	11.4	12.0

Source: Eurostat.

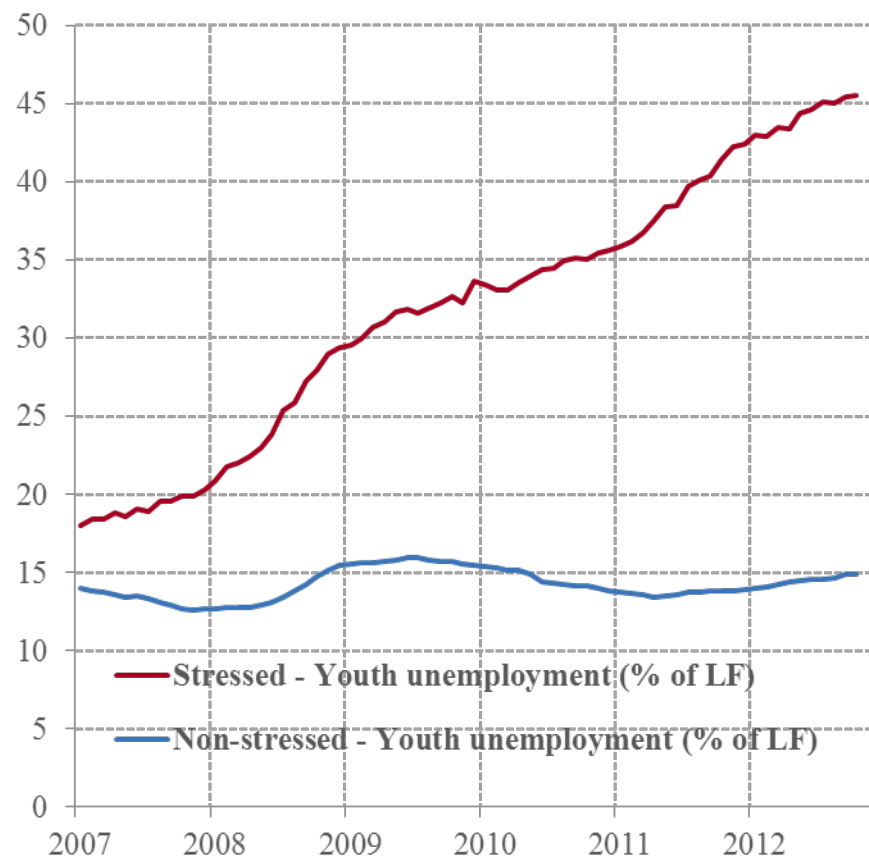
* December 2012 for Greece.

Rebalancing costs in the euro area

Youth unemployment rates across countries

Euro area youth unemployment – stressed vs non-stressed countries

(% of labour force of the relevant age group)



Source: Eurostat.

Note: Stressed countries: GR, PT, IE, ES, IT, CY and SI.

Youth unemployment rates across countries

(% of labour force of the relevant age group)

	2008	2009	2010	2011	2012	Feb. 2013*
Greece	22.1	25.8	32.9	44.4	55.4	58.4
Portugal	20.2	24.8	27.7	30.1	37.7	38.2
Ireland	13.3	24.0	27.6	29.1	30.4	30.8
Spain	24.6	37.8	41.6	46.4	53.2	55.7
Italy	21.3	25.4	27.8	29.1	35.3	37.8
Cyprus	9.0	13.8	16.6	22.4	27.8	31.8
Slovenia	10.4	13.6	14.7	15.7	20.6	23.2
Germany	10.6	11.2	9.9	8.6	8.1	7.7
Euro area	16.0	20.3	20.9	20.8	23.1	23.9

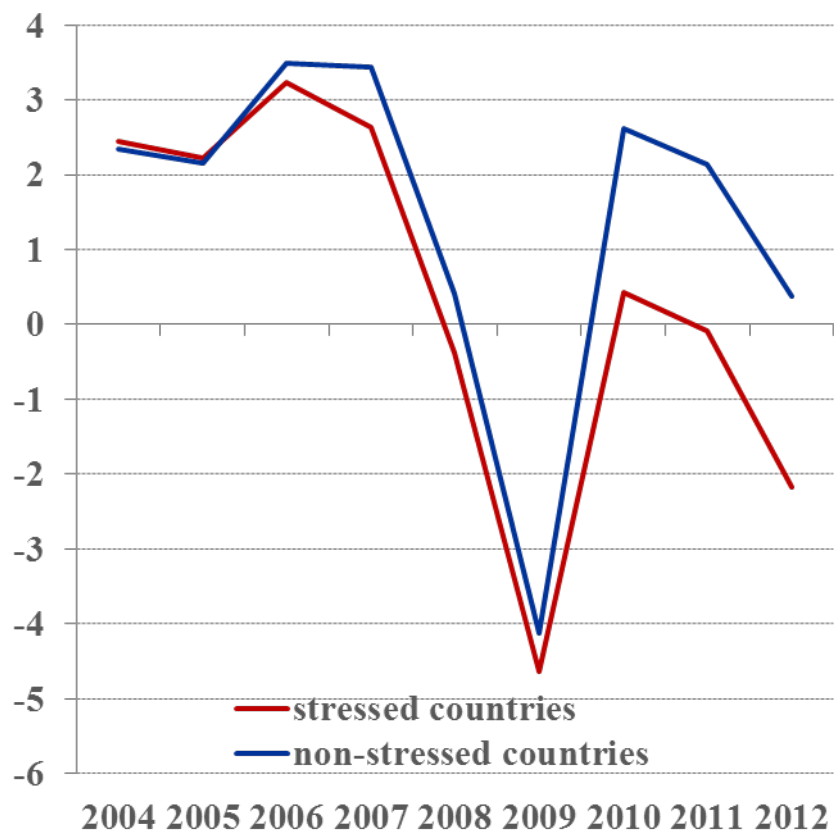
Source: Eurostat.

* December 2012 for Greece and Cyprus.

Rebalancing costs in the euro area

GDP growth rates across countries

GDP growth in stressed vs non-stressed countries (annual growth, %)



Source: Eurostat.

Note: Stressed countries: GR, PT, IE, ES, IT, CY and SI.

GDP growth rates across countries (%)

	2009	2010	2011	2012	2013 (forecast)	2014 (forecast)
Greece	-3.1	-4.9	-7.1	-6.4	-4.4	0.6
Portugal	-2.9	1.9	-1.6	-3.2	-1.9	0.8
Ireland	-5.5	-0.8	1.4	0.9	1.1	2.2
Spain	-3.7	-0.3	0.4	-1.4	-1.4	0.8
Italy	-5.5	1.7	0.5	-2.4	-1.0	0.8
Cyprus	-1.9	1.3	0.5	-2.4	-3.5	-1.3
Slovenia	-8.0	1.1	1.0	-2.2	-2.0	0.7
Euro area	-3.8	1.9	1.6	-0.5	-0.3	1.4

Sources: Eurostat and European Commission (Economic Forecast)

Key conclusions

- **Financial integration progressed during 2012 as markets fragmentation has been reduced.** In particular, sovereign bond spreads declined, especially in countries where they had increased the most in the preceding months. The degree of adjustment in both internal and external imbalances achieved by several stressed countries contributed also to the receding financial fragmentation.
- In spite of the improvements in market conditions, **the climate in the financial markets remains fragile.** The level of fragmentation remains high in some markets, e.g. money markets. **The improvement in financial conditions has not been reflected on the real side of the economy. Economic growth in Europe will be essential to complete the adjustment that took place.**
- Therefore, it is of paramount importance that the momentum is maintained towards structural reforms at national level and towards building a stronger Economic and Monetary Union through European-level institutional reforms. Further progress towards the establishment of the **banking union** (SSM, SRM and harmonised DGS) will be a critical factor underpinning future growth and financial integration.